

Martin Wolf: Japan is as far from a cure as ever

By Martin Wolf

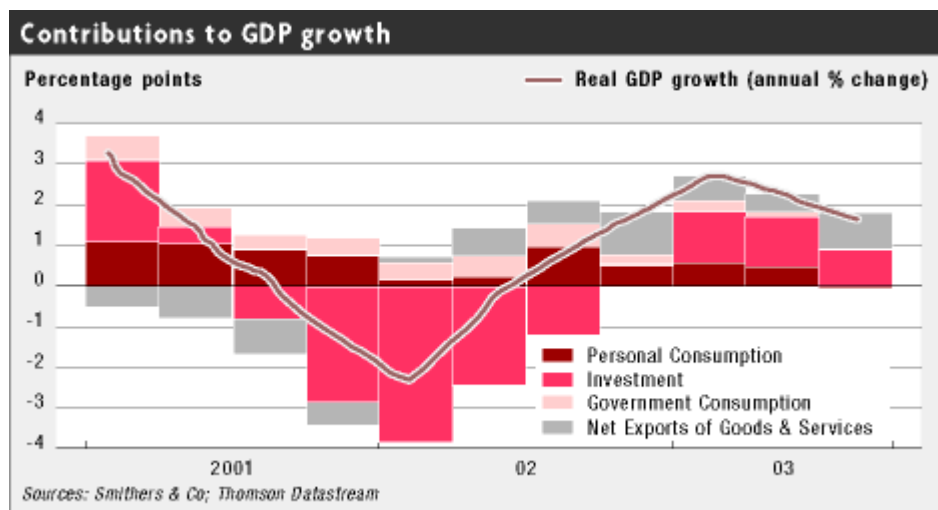
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The Japanese economy is back. Or so optimists believe. But we have been here before, in the brief recoveries of 1992, 1997 and 2000. That is a good reason for scepticism. But there is something even more telling about this recovery than that: it is happening more because Japan has *not* reformed than because it has.

Let us start with the good news: the economy has now enjoyed seven successive quarters of economic growth. According to the latest economic survey of Japan from the Organisation for Economic Co-operation and Development, gross domestic product is set to rise by 2.7 per cent this year. Next year, growth could be 1.8 per cent.

The proximate causes of this recovery are traditional. In 2002, exports grew by 8.1 per cent. With imports rising by only 2 per cent, net exports increased by 0.7 per cent of GDP. This offset the decline in domestic investment, to generate modest economic growth (see the chart for the quarterly breakdown). Then, in 2003, private non-residential investment picked up sharply, with growth forecast at 10.3 per cent. This has combined with growth in net exports of 0.5 per cent of GDP to deliver satisfactory overall growth.

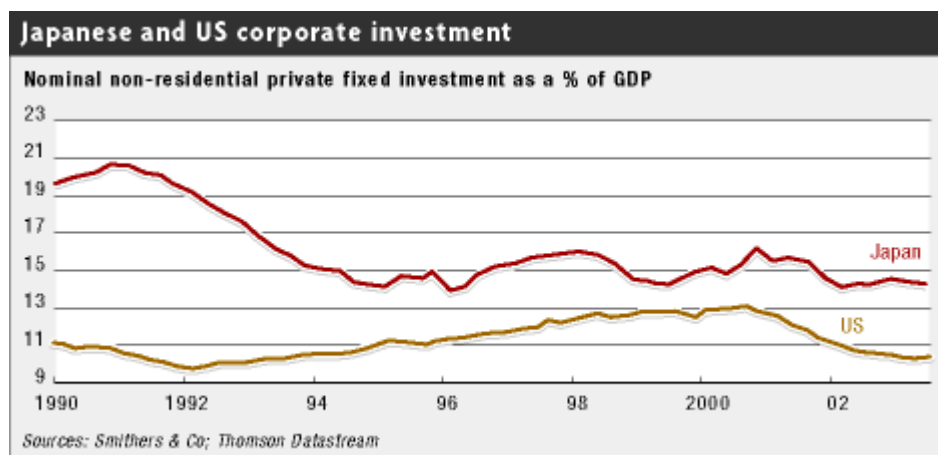
How, I wondered during a recent visit, would this story look in Tokyo? Confused is the answer. The debate remains as divided as before between "supply-siders", who emphasise microeconomic reform, "bank-siders", who emphasise the need to recapitalise the banks, and "demand-siders", split, in turn, between monetarists, who demand more money, and fiscalists, who recommend bigger fiscal deficits. But two points seem to be widely agreed, at least among the insiders: first, the external sector is proving a great boon; second, the Bank of Japan has moved from being part of the problem towards being part of the solution.



Both points are right. Exports rose at a 12 per cent annual rate during the 18 months through mid-2003. A third of the increase in exports over that period was to Asian markets, led by China. Similarly, the prevarication of the Bank of Japan under Masaru Hayami, its former governor, has gone. Under its new management, the bank is committed to sustaining zero interest rates and quantitative monetary easing until the majority of board members forecast above-zero inflation.

A bigger current account surplus and a more aggressive monetary policy are necessary conditions for ending the Japanese malaise. Japan needs to export more of its surplus private savings. It also needs inflation, to reduce the overhang of domestic debt. But the changes so far are inadequate.

The current account surplus is still about 3 per cent of GDP, which is far too small to mop up the country's excess of private savings over current (let alone equilibrium) levels of private investment. Similarly, monetary policy is still not aggressive enough to end the deflation that has been under way since the mid-1990s. The GDP deflator - the broadest measure of price changes in the economy - fell by 1.7 per cent last year. According to the OECD, it is set to fall by another 2.5 per cent in 2003. Moreover, the OECD forecasts a significant output gap - and so persistent deflationary pressure - at least until 2005.

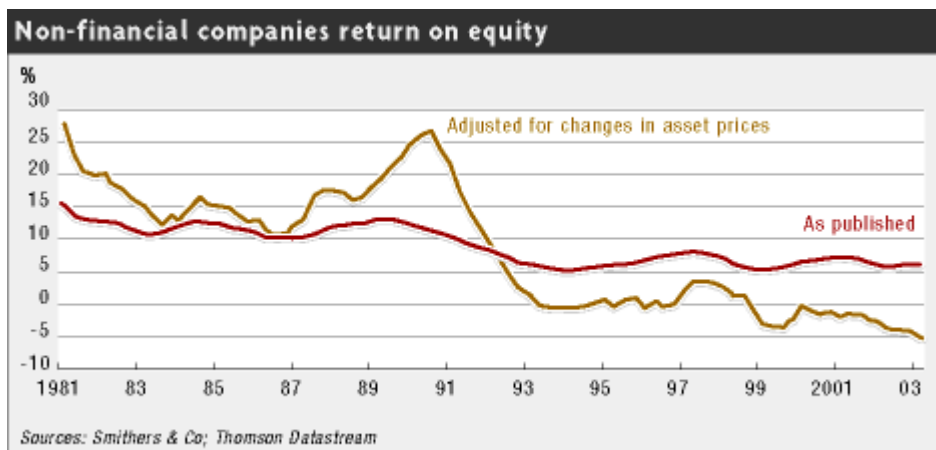


These are not the only reasons for doubt, however. Those who argue that the country faces structural handicaps are right. It is just that they usually fail to identify them correctly, since they are more macroeconomic than microeconomic. Among the most significant features is a corporate sector that invests far too much. For this reason the present recovery, which is built, as usual, on a surge in private investment, rests on sand.

Andrew Smithers, of London-based Smithers & Co, has done more than anybody else to explain how peculiar the behaviour of the Japanese corporate sector is. As the chart shows, the share of corporate investment in Japanese GDP has been consistently higher than in the US. Yet the US economy has been growing at a little over 3 per cent a year over the past 10 years, while Japan's has limped along at just over 1 per cent.

The US labour force is also growing at about 1 per cent a year, while the Japanese labour force is shrinking at 0.5 per cent a year. Both of these are reasons for expecting corporate investment to be substantially higher in the US than in Japan. If both economies were equally competitive and open to international capital markets, that would be the case. The evidence shows they are not.

Because it takes almost three times as much capital to produce an additional unit of GDP in Japan as in the US, Japanese returns on capital must be much lower, probably less than half. This might cease to be the case if, as the supply-siders believe, aggregate productivity growth were to rise far more quickly than in the US. That is not inconceivable, since Japan's output per hour is only 70 per cent of US levels. But no sign of such a renaissance can be seen. On the contrary, the growth of labour productivity has been falling in the past decade, to below 2 per cent a year.



Why then does investment remain so stubbornly high? One reason is that the unreformed Japanese corporate sector is indifferent to returns to shareholders. Another is that profitability is mismeasured, because of the failure to understand the implications of deflation. Under deflation, real interest rates are higher than nominal ones. For a highly indebted corporate sector, this makes a huge difference to returns on equity. Adjusted for changes in asset prices, for example, the return on equity moves from plus 5 per cent to minus 5 per cent (see chart).

One implication of this analysis is that, to the extent that this recovery lasts, it can only be because Japanese companies continue to waste capital. It is, in other words, only because Junichiro Koizumi, the prime minister, has made so little difference to the operations of Japan Inc that an investment-led recovery is under way. But it is unlikely to last, for the same reason. Losing money is not a sound long-run proposition even for a corporate sector as well-shielded from capital markets as the Japanese.

What is happening at the moment is business as usual. Japan is benefiting from growth overseas, together with successful management of the domestic symptoms of its disease. That is certainly less painful than treatment. But Japan is as far from a cure as ever.

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